L. R. B. & M. JOURNAL

VOLUME 20 NUMBER 6
NOVEMBER, 1939

Published by
YBRAND, ROSS BROS. & MONTGOMERY
Accountants and Auditors

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L. R. B. & M. JOURNAL

VOLUME TWENTY NOVEMBER, 1939 NUMBER SIX

The Penalty Tax on Corporations Improperly Accumulating Surplus

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An important indication that the Treasury contemplates the tightening of enforcement of Section 102 of the Internal Revenue Code was the promulgation, on July 26, 1939, of T.D. 4914. The Treasury Decision is quoted, in part, as follows:

Instructions: (a) Returns filed by the following classes of corporations will be given close attention to determine whether section 102 is applicable:

(1) Corporations which have not distributed at least 70 per cent of their earnings as taxable dividends.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding 70 per cent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

(b) In so far as the classes of cases referred to in (1), (2), (3), and (4) are concerned, the examining officer's report in every instance shall contain a specific recommendation for the application or nonapplication of section 102.

The ruling further makes evident that tentative determination of liability, at least of corporations coming within classifications (1) to (4) described above, is in future to be made by local revenue agents as a part of their routine examinations and recommendations. This is a decided change from the Treasury's former procedure under which such determinations by local examining agents were the exception and not the rule.

If past experience of the difficulties encountered with respect to action by revenue agents on deductions for stock losses and bad debts is any criterion, it may be ex-

pected that many corporate taxpayers, who have withheld distribution of earnings because of wholly legitimate motives, will become involved in controversy with the Treasury Department over proposed assessments of the tax under Section 102, by reason of the recommendations which may be contained in the reports of examining agents.

With such a prospect in mind, it becomes of special importance that, before the end of the present fiscal year, and of each fiscal year in the future, so long as the law remains unchanged, corporate officers review the corporation's situation with respect to Section 102 to determine whether any action is required.

Purpose of Section 102

Under Section 102 a tax is imposed upon every corporation which is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of its parent corporation, by permitting earnings or profits to accumulate, instead of being divided or distributed. Personal holding companies as defined in Title 1A of the law and foreign personal holding companies as defined in Supplement P thereof are excluded from the provisions of the section.

The penalty tax, which is in addition to the ordinary income and excess-profits taxes, is imposed at the rate of 25 per cent of the "undistributed Section 102 net income" (as defined in the law) not in excess of $100,000 and at the rate of 35 per cent on the excess of such net income over $100,000.

The section also provides that the fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders. This article does not deal with such corporations.

Liability arises, not because of the accumulation of earnings or profits, but because of the purpose or motive of such accumulation. The provision is not new. A corresponding provision has been in every revenue act beginning with that of 1913. Prior to the Revenue Act of 1921, however, the tax was laid upon the shareholder and not against the corporation.

Application to Corporations in General

A new paragraph has been added to Section 102 in the Revenue Act of 1938. The paragraph, enacted as Section 102 (c) and designed to strengthen the enforcement of the provision, is as follows:

Evidence Determinative of Purpose: The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

The corresponding provision of

the 1936 and prior Acts is quoted for purposes of comparison:

> The fact that . . . the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

Whether the change in the language will accomplish its purpose is problematical. That the Treasury so believes is apparent from its sweeping interpretation of the paragraph as quoted below:

> If earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Act adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company the existence of such an accumulation is *determinative* of the purpose to avoid surtax, unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable (Art. 102-2, Reg. 101).

Notwithstanding the change in the law, the basis for the penalty tax remains exactly as it was in prior laws. In every case to which the tax is applicable the undistributed earnings or profits must have been retained for the purpose of preventing the imposition of the surtaxes which the stockholders would pay if such earnings or profits were distributed.

Distribution of Earnings or Profits Available for Dividends

For the purpose of determining liability or exemption with respect to the surtax, "earnings or profits" may be regarded for convenience as the equivalent of "Section 102 net income."

In some cases there may be doubt as to the amount of earnings or profits available for dividends. Suppose, for example, that after the taxable year, the Treasury finds a deficiency in income tax resulting from an increase in the taxable net income and consequently in the earnings or profits. If such determination is sustained, or is acquiesced in by the taxpayer, could it be said that the additional earnings or profits were withheld from distribution for the purpose of preventing surtaxes on the shareholders?

If the taxpayer has distributed all its available earnings or profits on the basis of its return as originally filed, it would seem most unlikely that the additional earnings or profits, of which the taxpayer had no knowledge during the taxable year, could have been withheld from distribution for the proscribed purpose. If, however, the taxpayer had failed to distribute its known earnings or profits during the taxable year and was found subject to the penalty tax, it might be held that the tax applied to the earnings or profits as finally determined, on the ground that the taxpayer's intention was to refrain from making any distribution.

In determining the amount of

earnings or profits available for dividends, the actual cost to the corporation of assets sold should be used to determine gain or loss, and not the income tax basis of the assets [*W. S. Farish & Co.*, 38 B. T. A. 150, aff'd 104 Fed. (2d) 833]. This is important in cases where corporations have acquired assets which, for the purpose of determining income tax, take the basis of the transferor. Usually, such basis is greater or less than the cost. It would seem that the reasoning in the *Farish* case would require that gain or loss on sale of property acquired as paid-in surplus, or in any exchange where the transferor's basis is used for income tax purposes, should be computed on the basis of actual cost.

If a corporation has an operating deficit at the beginning of the taxable year, the amount available for distribution as dividends is limited to the excess of the earnings or profits for the taxable year over the operating deficit (*W. S. Farish & Co., supra*).

> The section . . . recognizes the right of every corporation to keep its capital intact and provide a surplus for its reasonable needs [*United Business Corporation of America*, 19 B. T. A. 809, aff'd 62 Fed. (2d) 754, cert. den. 290 U. S. 635].

In determining the amount of earnings or profits available for distribution in the taxable year in the case of corporations who report on the accrual basis, it should be kept in mind that part of such earnings or profits is uncollected at the end of the year and is not available for dividends. This applies to the uncollected profits reflected in outstanding notes and accounts receivable and other current assets. Accrued or deferred income which is subject to income tax on the accrual basis is not income available for dividends until realized in cash or the equivalent. The section does not require that a corporation borrow money to pay dividends.

In one case the Board held that, where the earned surplus of a corporation (not a mere holding or investment company) was dissipated by unrealized losses and depreciation in the value of its assets, so that the total amount of liabilities and capital stock approximately equalled the actual value of the assets, the corporation was not subject to the penalty tax [*C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511 (N. A.)]. Depreciation in any of the assets is evidence to be considered by the Commissioner and the Board in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business (*Helvering* v. *National Grocery Co.*, 304 U. S. 282). The assets would be useful to the business only to the extent of their actual market values. The fact that they cost a greater amount would not benefit the business (*C. H. Spitzner & Son, Inc., supra*).

Percentage of Earnings or Profits to Be Distributed to Stockholders

Neither the law nor the regulations specify any minimum percentage of earnings which must be distributed in order to escape liability to the penalty tax. The fact that the Treasury in T. D. 4914, *supra,* has made a separate classification of corporations which have not distributed at least 70 per cent of their earnings, does not appear of any particular significance, unless it is intended to scare timorous taxpayers. In each case the "reasonableness" of the accumulation of earnings or profits must depend on the particular facts. In some cases, it would be reasonable to withhold 100 per cent of earnings from distribution, while in an exceptional case even distributions in excess of 70 per cent might be regarded by the Treasury as insufficient. If the stock is closely held, the Treasury is likely to apply more rigorous tests to the amount of undistributed earnings, than if the stock is widely distributed.

Unreasonable Accumulations of Earnings or Profits

Section 102 (c) holds that the fact that earnings or profits are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon stockholders. This determination can be rebutted only by the clear preponderance of evidence to the contrary.

The penalty tax is laid upon the earnings or profits of the taxable year and not upon the accumulated earnings of prior years, whether such accumulations are considered reasonable or unreasonable. The amount of such accumulations, however, is a factor to be considered in determining the reasonable needs of the business in connection with the earnings or profits withheld from distribution during the current year.

The amount of surplus required to be retained for the reasonable needs of the business is a question of fact to be decided on the basis of the nature of the business, the volume of business done, the keenness of competition, principles of sound business management, the conditions of the times, and the threat of adverse legislation against the industry [*Seaboard Security Co.,* 38 B. T. A. 560 (A)].

An accumulation of earnings or profits is unreasonable if it is not required for the purposes of the business considering all the circumstances of the case (Art. 102-3, Reg. 101). The regulations make it clear, however, that it is not intended to prevent accumulations of surplus for the reasonable needs of the business (Art. 102-3, Reg. 101).

The manner in which the surplus of a corporation is invested is an important factor in determining whether the accumulation of earn-

ings or profits is reasonable or unreasonable.

MANNER OF INVESTMENT AND APPROPRIATION OF SURPLUS MAY INDICATE REASONABLENESS OF ACCUMULATIONS, OR OTHERWISE

If the surplus is invested in plant or equipment which is used in the business, obviously such surplus is not available for dividends and the accumulations are not unreasonable. (*Cf.* Art. 102-3, Reg. 101.)

Undistributed income is properly accumulated if retained for working capital needed by the business (Art. 102-3, Reg. 101).

Earnings are not unreasonably accumulated if, in accordance with contract obligations, the undistributed income is placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation (Art. 102-3, Reg. 101). Actual payments of indebtedness, in whole or in part, in accordance with contractual obligations would likewise be reasonable dispositions of undistributed income.

But payment of indebtedness greatly in excess of contractual obligations was held by the Board to be made, not on account of the reasonable needs of the business, but for the express purpose of averting the application of Section 104 (102 in present law) [*Mead Corporation,* 38 B. T. A. 687; *United Business Corporation of America,* 33 B. T. A. 83].

It should not follow, however, that all payments or appropriations in excess of contractual obligations are to be considered as evidence of a purpose to avoid the penalty tax. If a substantial amount of capital obligations is due to mature in the early future, it would be the part of wisdom to provide for payment of such indebtedness out of current earnings, if not otherwise provided for.

Favorable market conditions may indicate the advisability of retirement of bonded indebtedness before maturity either by purchase on the market or by call. It might be sound business judgment to use a part of current income to take advantage of such conditions.

The policy of "ploughing back" a reasonable part of the earnings of an active business corporation for purposes of normal business expansion is still considered sound and legitimate by the Board and the courts [*J. E. Baker Co.,* B. T. A. Memo. Op. June 26, 1939; *Cecil B. deMille Productions, Inc.,* 31 B. T. A. 1161, aff'd 90 Fed. (2d) 12, cert. den. 302 U. S. 713]. "Reasonable business ambition is a factor to be taken into consideration" (*Cecil B. deMille Productions, Inc., supra*).

It requires no argument to support the premise that the cited sections do not contemplate that a business should remain static; it must be assumed that any business shall have the right to grow. Necessarily incident to the exercise of this right are the making and pursuit of

plans both as to organization and as to finance which will permit the accomplishment of the contemplated development (*William C. deMille Productions, Inc.*, 30 B. T. A. 826).

Increased volume of business may make necessary the enlargement, expansion or modernization of the plant or equipment. Where production is lagging behind unfilled orders, it may indicate inadequacy or inefficiency of the plant and equipment. Early replacement of depreciated and outmoded equipment may be indicated. In a normally growing business, the reserves for depreciation are not usually sufficient to provide for replacements. Old equipment ordinarily is replaced by new equipment of more modern design and greater capacity with resulting increased cost. It is proper to provide for such increases from current income, whenever possible.

The introduction of a new product, or the keenness of competition for business, may require extensive advertising campaigns. Appropriations for such advertising, although not deductible for income tax purposes until contracted for or used, are a legitimate use of undistributed income. Development of a new product might also be expected to result in substantial expenditures, requiring the retention of surplus earnings until the sale of the product is on a sustaining basis.

There are many legitimate purposes for which undistributed income may be used. It is desirable that appropriations for such purposes be authorized by the directors, and made a matter of record by suitable minute or otherwise. Although such appropriations are not income tax deductions, they go to make up "the clear preponderance of the evidence" required to overcome the statutory presumption that the earnings were retained for the purpose of avoiding surtaxes on the stockholders.

Temporary investment in income-producing securities of working capital or other funds not needed because of falling off in business or other temporary conditions does not indicate the improper purpose [*C. H. Spitzner & Son, Inc., supra*]. However, it must be shown that the intention is to make temporary investments and not permanent ones, otherwise, the Treasury holds that if undistributed earnings are invested in assets having no reasonable connection with the business, a purpose to avoid the surtax is thereby indicated. (Art. 102-2, Reg. 101.) The investment of depreciation reserves and proper surplus appropriations in marketable securities, so that the funds may be available when required, would seem to bear a reasonable connection with the business.

In determining the reasonableness of accumulated earnings or profits, the nature of the business is a factor to be considered. A stabilized business which is not subject

to marked fluctuations in earnings may not require the retention of as great a proportion of its earnings as a business which is subject to highly speculative and changeable conditions of business activity. In some lines of business one profitable year is alternated with one or more unprofitable years. Obviously, in such businesses, the profits of the profitable years must carry the losses of the lean years.

Unsettled domestic or foreign business conditions, including unfavorable or restrictive legislation effective or impending, may indicate the need for a high degree of liquidity and justify the accumulation of a substantial part of the earnings.

Loans to Stockholders

Withdrawals by stockholders of funds of the corporation as personal loans, or expenditures of funds by the corporation for the personal benefit of the stockholders, will be considered by the Treasury as evidence of an intention to avoid the surtax. (Art. 102-2, Reg. 101.)

Large loans by corporations to controlling stockholders have been found fatal to a successful defense against assessment under Section 102, or the corresponding provisions of prior laws. [*Helvering* v. *National Grocery Co., supra; United Business Corporation of America* v. *Commissioner*, 19 B. T. A. 809, aff'd 62 Fed. (2d), 754, cert. den. 290 U. S. 635; *William C. deMille Productions, Inc.*, 30 B. T. A. 826.]

Distribution of Large Portion of Earnings of the Taxable Year

Although a corporation may have distributed a large portion of its earnings for the taxable year, it may still be subject to the tax on the undistributed portion if it be found that there is an unreasonable accumulation of earnings or profits, or that the corporation was formed or availed of to avoid surtaxes on the stockholders (Art. 102-2, Reg. 101).

The normal growth and development of the business of an active corporation would ordinarily require the retention of a part of its earnings.

Accumulated Earnings of Affiliated Corporations

The Section 102 penalty tax applies if a corporation is formed or availed of for the purpose of preventing the imposition of individual income surtaxes, not only upon its own shareholders, but upon the shareholders of any other corporation [Sec. 102 (a)].

Thus, a wholly owned subsidiary is liable under Section 102 if its earnings are withheld from distribution to its parent corporation for the purpose of preventing the imposition of surtaxes on the stockholders of the parent corporation.

If the parent corporation has an

operating deficit equal to, or greater than, the accumulated earnings of the subsidiary, it would seem immaterial whether such accumulated earnings were considered reasonable or unreasonable and there would seem to be no basis for liability to the penalty tax.

Investment of Accumulated Earnings in Assets Having No Relation to Business

Investment by the corporation of undistributed earnings in assets having no relation to the business is indicative of a purpose to avoid surtaxes on the stockholders (Art. 102-2, Reg. 101). The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business (Art. 102-3, Reg. 101). This ruling of the Treasury has the support of the courts and the Board [*Helvering* v. *National Grocery Co., supra; United Business Corporation of America* v. *Commissioner, supra*]. It has already been pointed out that investment of earnings of active business corporations in income-producing securities is often necessary and advisable and evidence of sound business practice. In such cases it should not be said that the investments have no relation to the business.

The Business of the Corporation

Proper accumulation of earnings is determined under Section 102 (c) by "the reasonable needs of the business." It thus becomes necessary to examine what constitutes the "business" of the corporation.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the penalty tax (Art. 102-3, Reg. 101).

If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance, although not in legal form, the business of the first corporation. Earnings or profits of the first corporation, put into the second through the purchase of stock or otherwise, may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business (Art. 102-3, Reg. 101).

The regulations provide that investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The regulations also hold that the business of one corporation may not be regarded as including the business of another unless the other corporation is a mere instrumentality of the first; to establish this it is ordina-

rily essential that the first corporation own all or substantially all of the stock of the second corporation (Art. 102-3, Reg. 101).

The foregoing regulation appears to be unnecessarily restrictive. Many cases are known where one corporation's stock ownership of another is much less than "substantially all" and yet, because the second corporation is a valuable medium of distribution for the first corporation's products or an important source of supply for its raw materials, or because of other close business relations, it is very much the business of the first corporation to finance the activities of the second corporation.

Conclusion

Corporations with few stockholders, or whose directors or officers own or control large blocks of the corporation's stock, are more vulnerable to attack than are other corporations. Special attention should be given by such corporations to the factors herein discussed, so that no such corporation will become subject to the penalty tax because of lack of timely consideration thereof.

Even if the corporation retains its earnings and pays the tax under Section 102, the normal taxes and surtaxes payable by stockholders, when the earnings are distributed, have not thereby been avoided. Such taxes on the stockholders will have been merely postponed until distribution is actually made. Subjection of earnings to the penalty tax under Section 102 does not exempt such earnings from tax in the hands of the stockholders upon distribution.

The penalties are severe and the avowed purpose of the Treasury is to collect them; therefore the question *"Are we liable?"* is of much greater importance than at any time in the past.

Suggestions Regarding the Federal Income Tax Law and Its Administration

By W. H. DAVIDSON
(*New York Office*)

During the late Summer Mr. John W. Hanes, Acting Secretary of the Treasury, wrote a letter to a considerable number of business men, inviting their cooperation with the Subcommittee of the Ways and Means Committee of the House of Representatives which had been instructed (H. Res. 277) to make a thorough study of internal revenue taxation during the recess of the Seventy-sixth Congress. Secretary Hanes desired especially to get the views of business men in the effort to work out a tax revision program which would further improve the laws relating to individual and corporation taxes, the regulations relating thereto and the administrative procedure generally.

At the recent annual meeting of the American Institute of Accountants in San Francisco its Committee on Federal Taxation submitted a very informing report with various suggestions for improvement of the existing tax law. It is to be hoped that the Treasury and the Congressional Subcommittee will give serious consideration to these suggestions because the adoption of them would contribute to greater equity as well as to better administration.

This seems to be an opportune time to express a few further thoughts regarding possible improvements in the federal tax law and its administration, from an accountant's point of view.

DISTRIBUTIONS IN PARTIAL LIQUIDATION

Under existing law a gain realized by an individual stockholder from the receipt of a distribution in partial liquidation of a corporation is treated as a short-term capital gain, and is accordingly 100 per cent taxable regardless of the length of time the stock was held. However, if the distribution in partial liquidation results in a loss, and if the stock was held more than eighteen months, the loss is considered long-term and only a portion of the loss is deductible.

There is no logical basis for this discrimination. An example of a distribution in partial liquidation is the retirement of a preferred stock issue. A taxpayer who is properly advised will sell his stock before it is redeemed and will have a long-term capital gain if he has held the stock more than eighteen months. The innocent taxpayer who does not have tax advice will permit the

stock to be redeemed and find the profit 100 per cent taxable.

Where the stock or security has been held more than eighteen months: (1) a gain or loss realized from the redemption of a bond or note is long-term; (2) a gain or loss realized from the complete liquidation of a corporation is long-term; (3) a loss resulting from worthlessness is long-term; and (4) a *loss* resulting from a distribution in partial liquidation is long-term. A *gain* resulting from a distribution in partial liquidation should likewise be considered long-term, if the stock has been held more than 18 months.

Liquidation of Domestic Corporations

The 1938 Act, in certain circumstances, allowed the liquidation of domestic corporations without the immediate recognition of gain to the stockholders. The liquidation had to occur in December, 1938. The provision was not widely publicized, and many taxpayers overlooked the opportunity. It is suggested that another opportunity be afforded to accomplish such liquidations so that taxpayers who were not familiar with the provision may receive its benefits.

Obsolescence of Natural Deposits

Existing law, as construed by the Treasury, makes no provision for obsolescence of natural deposits, but provides only for a reasonable allowance for depletion. Depletion is computed on the basis of production.

There are cases where, as a result of technological or other changes, a natural deposit gradually loses its usefulness. Competing products become more economical or efficient. As the use for the product declines the depletion allowance on a production basis becomes smaller, and if production is discontinued the taxpayer is allowed no deduction whatever unless the property is definitely abandoned. Abandonment, from a business standpoint, may be unwise.

This situation should be remedied by an amendment permitting the deduction of a reasonable allowance for obsolescence in the case of natural deposits, as in the case of other property used in the trade or business.

Dividends Paid from Current Profits

If a corporation which has an operating deficit of $1,000,000 at the beginning of a taxable year earns $100,000 during the taxable year and pays a dividend of $100,000 during such year, under existing law the distribution of $100,000 is taxable as income to the stockholders. It is obvious to an accountant that under such circumstances the distribution of $100,000 is from capital, and in the opinion of many attorneys there is a serious question

as to whether it can be constitutionally taxed to the stockholders. But it should not be necessary to litigate an unfair provision. The law should be amended to read as it did prior to 1936; that is, a dividend should be defined as only a distribution out of earnings or profits accumulated after February 28, 1913.

Interest on Refunds and Deficiencies

If a taxpayer pays the income tax in four instalments and an additional tax is assessed, the additional tax bears interest from the date of the first instalment. On the other hand if the taxpayer is allowed a refund the refund bears interest only from the date of payment of the last instalment of the tax, assuming that the refund does not exceed the amount of the last instalment. Though the difference is usually not large in dollars, it is inequitable and the discrimination is often a source of irritation to taxpayers.

Foreign Tax Credit

Section 216 (b) of the 1939 Act remedied a serious inequity in the prior law under which a corporation which received domestic dividends was prevented from securing a full credit for income taxes paid to a foreign country, even though the rate of foreign income tax was less than the United States rate. The 1939 amendment applies only to taxable years beginning after December 31, 1939. The injustice of the prior acts was patent; the 1939 amendment should be modified to make it apply retroactively.

Capital Stock Tax

In arriving at the adjusted declared value for capital stock tax purposes the law allows the deduction of "the cash, and the fair market value of property, distributed to shareholders." In a great many cases the original declared value is substantially in excess of the fair market value of all of the net assets of the corporation. In such a case, under the Treasury's interpretation of the statute, when a corporation is completely liquidated it is allowed to deduct from the original declared value only the value of the assets distributed, regardless of the amount of the original declared value. Consequently, although the corporation has no remaining assets, there is a balance of adjusted declared value on which tax must be paid. The law should provide that when a corporation is completely liquidated the entire balance of the declared value should be deducted.

Last-In, First-Out Inventory Method

Under the last-in, first-out inventory method authorized in the 1939 Act the inventories used for tax purposes must be taken at cost. Last-in, first-out is merely a method of determining cost. Whatever

method is used for determining cost, whether it be first-in, first-out, last-in, first-out or average, the age-old principle of cost or market whichever is lower as a basis for inventory valuation should not be affected. The law should allow inventories to be priced at the lower of (a) last-in, first-out cost, or (b) market.

Earned Income Credit

The "earned net income," upon which the earned income credit is based, may not exceed $14,000 under the present statute. If it is considered fair to tax earned incomes at lower rates than unearned incomes there is no logical reason for limiting the earned net income to $14,000, unless it is believed that no one can fairly earn more than $14,000.

Incentive Taxation

There has been much discussion in the past year of incentive taxation, and a Congressional Committee has given the subject considerable study. When this subject was first raised the writer expected that business men would strongly favor incentive taxation. Though opinion is by no means unanimous, it now appears to the writer that business men generally oppose the principle. They doubt if it will accomplish the desired result; they question whether it would be fair to all taxpayers; and what is most important, they oppose the principle of using the tax laws to accomplish social objectives. If we approve the principle of offering a tax credit for doing something which seems socially desirable, we cannot consistently oppose the principle of a tax penalty for doing something which seems socially undesirable.

In this class falls the tax on intercompany dividends, which was enacted to discourage holding companies. In recent years such dividends were taxed for the first time in 1936. Most of us have forgotten that such dividends were taxed as far back as 1917. In Montgomery's *Income Tax Procedure* for 1917, there appears the following comment, which might properly have been written yesterday:

> The intent of this provision is obvious in that a penalty is laid upon so-called holding corporations. For some inscrutable reason the lawmakers decided that moral turpitude was involved in one corporation's holding stock in another, irrespective of the object intended or result reached, so in order to prevent or, lacking prevention, to punish such offenders, it is provided that a double tax shall be paid on the income represented by dividends paid by one corporation to another.

The tax on intercompany dividends was repealed in the Revenue Act of 1918, and it was not reenacted until 1936. The excuse for the restoration of an unsound provision was not persuasive to those interested in fair taxation.

DEPRECIATION

There has been much criticism by taxpayers of the policy followed by the Treasury in recent years with respect to deductions for depreciation. The data which the Treasury has required taxpayers to compile have indicated conclusively, however, that in some cases the depreciation rates used, even though adopted in good faith, have been excessive. When this situation exists, the Treasury is not properly subject to criticism for reducing the rates.

However, there are logical grounds for criticizing the manner in which the Treasury has applied the rate reductions. In most cases the depreciation rates used by the taxpayers were rates arrived at by agreement with the Treasury years ago and accepted by the Treasury over a long period of years.

When the taxpayers were requested to prepare schedules under Treasury Decision 4422, and these schedules indicated that the depreciation rates were too high, the Treasury reduced the rates retroactively to all years not barred by the statute of limitations. In some cases where consents had been filed extending the period of limitation the rates were reduced retroactively for a period of five or six years, and taxpayers were faced with substantial additional assessments which they had never anticipated.

It is submitted that when a taxpayer and the Treasury agree on a depreciation rate, such rate should be accepted until it is determined that the rate is excessive. When the Treasury determines that the rate is excessive the taxpayer should be notified that in tax returns for *subsequent* years it will have to use the lower rate. If this procedure is followed a corporation can have some reasonable knowledge of its tax liability at the time the tax returns are filed, at least with respect to depreciation, which it does not have under present procedure.

When the Treasury has applied reductions in depreciation rates retroactively, it has generally not reduced the rates for years in which the taxpayer sustained net losses, if the statute of limitations would prevent the assessment of additional taxes for such years. Since the taxpayer secured no tax benefit from the excessive depreciation rates in loss years it would be only fair to reduce the rates for such years as well as for the profitable years, the effect of course being that the recoverable cost will be increased. The statute requires that the tax basis be reduced by the depreciation allowed or allowable, whichever is greater, but when a net loss is sustained it is doubtful whether all of the depreciation shown in the tax return has been "allowed" within the meaning of the statute, merely because the Treasury did not consider it necessary to advise the taxpayer that the actual net loss was smaller than the net loss shown in the tax return.

ACCOUNTING METHODS

The accountants' most insistent and repeated complaint relates to the divergence between an income statement prepared under accepted accounting principles and the taxable income as often finally determined. It is believed that this divergence could be narrowed considerably without any statutory changes if more effect were given to two sections of the Internal Revenue Code.

Section 43 provides in part:

> The deductions and credits . . . provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred" dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.*

Section 42 provides in part:

> The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period.

Section 41 provides in part:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income (Italics supplied).

There have been innumerable rulings and decisions involving the question of when certain taxes accrue in the legal sense. These cases have involved a tremendous waste of effort. Under the sections quoted above the Treasury has ample authority to allow the deduction of taxes in the year in which a taxpayer deducts them in its books pursuant to a consistent accounting practice, and in the long run no revenue would be lost by such procedure.

The Board of Tax Appeals is apparently beginning to adopt this view. Though it has always been the Treasury's position that property taxes accrue on some fixed date, in two recent cases the Board allowed the accrual of such taxes on a monthly basis where the taxpayer's accounts were so kept. [*Godfrey L. Cabot, Inc.*, v. *Com'r*, 40 B. T. A. 64; *New Orleans Cold Storage and Warehouse Company, Ltd.*, v. *Com'r*, 40 B. T. A. 27.]

The Treasury should realize, as accountants realize so well, that income may be properly reflected in more than one way. For example, the New York State Franchise tax becomes a liability on November 1, but is paid for the privilege of doing business for the year beginning on that date. Some corporations

deduct the entire tax on November 1 and other corporations spread it over the ensuing year. The Treasury has always insisted on the first method, but under the quoted section of the Code it might properly accept either method, with considerable convenience to taxpayers and no loss of revenue.

Similar considerations apply in the case of deductions for losses, bad debts, worthless securities, and particularly to accruals of costs and expenses which have been sustained but which are somewhat indefinite in amount. A great deal of unnecessary effort and annoyance would be avoided if the Treasury allowed such deductions in the year in which a taxpayer, acting in good faith, deducts them in the books of account, and avoided the interminable haggling over the year of the expense or loss. It is hard to believe that any serious loss of revenue would be involved over a period of years.

Under the quoted provisions of the Code there is ample authority to allow rents received in advance, bonuses received for the execution of leases, etc., to be taken up as income over the terms of the contracts. The Treasury is to be commended for its recognition of the principle that a publisher may defer the unexpired portion of subscription receipts where its accounts are consistently so kept. (Letter to taxpayer, paragraph 6266 C. C. H.)

Properly construed, the quoted sections of the Code would also permit a roofer to deduct a reserve for repairs when he contracts to keep a roof in repair for a period of years, though the Treasury has not heretofore permitted such deductions. This reserve might be recognized under Section 43 as a deduction in a year other than the year paid or accrued in order to clearly reflect the income, or under Section 41 as a deferment of part of the gross income in accordance with the method of accounting regularly employed.

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. & Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

Tax Laws and Their Administration

In the July issue of the L. R. B. & M. Journal the writer made some editorial comment on the desirability of tax simplification and made mention of the study of internal revenue taxation by the Federal Government which, pursuant to a resolution of Congress, was to be made by a Subcommittee of the Ways and Means Committee.

Since then Mr. John W. Hanes, Under Secretary of the Treasury, has sent a letter to a considerable number of persons and organizations, asking their cooperation in the effort of the subcommittee "to work out a tax revision program to improve the laws relating to individual and corporation taxes, the regulations derived therefrom and the administrative procedure in their collection."

This issue of our JOURNAL contains an article by Mr. Davidson, of our New York office, which proposes a number of improvements. They might well be regarded as supplementing the excellent report of the Federal Taxation Committee of the American Institute of Accountants which was submitted at the recent annual meeting of the Institute.

It would be helpful, indeed, if the Congressional Committee would give serious consideration to bringing the determination of taxable income into just as close accord as possible with net income computed by following good accounting practice.

The recent issuance of Treasury Decision 4914 makes timely another tax article which appears in this issue, namely, The Penalty Tax on Corporations Improperly Accumulating Surplus, by Mr. Cordner, of our New York office. It should be helpful to both the members of our organization and our clients. It is important that while boards of directors on the one hand do not overlook the existence of Section 102 of the tax law and the application under certain circumstances of the penalty tax provided for therein, they also do not permit themselves to be stampeded into action which might be undesirable from the standpoint of the financial welfare of the corporation.

In other words, in formulating the dividend policy of a business corporation with substantial earnings, the directors should make such distribution of earnings as in their judgment is warranted after considering the various factors which must naturally be considered, including among others the profits realized, their availability for distribution (as contrasted with their use for plant additions or for needed increase in working capital), major replacements of plant which may be foreseen, special conditions which may possibly be impending as a result of war conditions, the financial position of the corporation after the payment of the dividend, and so on. Mr. Cordner's article seeks to analyze this difficult subject so as to bring helpful suggestions to those who have to deal with it.

Federal Tax Handbooks

The Ronald Press Company has announced, in response to many inquiries it has been receiving as to what new tax books Colonel Montgomery has been planning as a help in preparing returns to be filed at the close of the current tax year, that there will be no new edition of *Federal Income Tax Handbook* and *Federal Taxes on Estates, Trusts and Gifts* this year.

The Revenue Act of 1939, which was enacted by Congress in June last, applies for the most part only to taxable years beginning *after* December 31, 1939. Consequently,

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Institute Annual Meeting

The annual meeting of the American Institute of Accountants held in San Francisco September 18-21 was evidently considered by the membership to be of especial importance and interest as indicated by the relatively large attendance for a meeting in the Far West. Our firm was well represented as Messrs. Ross and Fischer were there from Philadelphia, Colonel Montgomery and Messrs. Sinclair and Staub from New York, Mr. Miller from Chicago, Mr. Haynes from Washington, and Mr. Ives from Atlanta. Mr. Keast, of San Francisco, Mr. Gibson, of Los Angeles, and Mr. Griffith, of Seattle, were naturally there as the meeting was in their "zone of operations." Numerous members of the San Francisco staff were in attendance, as well as Messrs. Walling and Hair from Los Angeles.

Mr. Keast was a member of the meetings committee which provided such an excellent program of professional papers, addresses and round-table discussions and of delightful entertainment. He also served as chairman of the golf committee—that important body in any organization meeting!—and had as a member of his committee Mr. Walter G. Draewell of our San Francisco office staff. Mr. Robert Buchanan, of our San Francisco office, was a member of the Finance Committee for the meeting.

One of the most important matters which came before both the Council and the full meeting of the Institute was the report of the Special Committee on Extensions of Auditing Procedure of which Mr. Staub was a member. The recommended extensions had to do with the examination of inventories and receivables. Some modification of the form of short report or "certificate" was also recommended. Some difference of opinion had developed within the Committee respecting certain details of the suggested procedures, or rather the statements regarding them in the accountant's report. Both majority and minority reports were submitted to the Council which, after devoting a whole afternoon to consideration thereof, approved the majority report. Upon the submission of the Council's report to the meeting of the membership meeting the following day, the report of the special committee was again discussed and after full consideration the Council's action was approved by a decisive majority.

Several members of the L. R. B. & M. organization contributed to the program of the round-table sessions. Mr. Staub submitted a brief paper on "Physical Tests of

Inventories, Their Purpose and Meaning" as a part of the round-table session devoted to "Inventories." Mr. Buchanan contributed a paper to the round-table discussion of "Whose Balance-sheet Is It?"

Mr. Ross concluded a five-year term of service on the Institute Council. Mr. Fischer was elected to a like term on the Council. Colonel Montgomery was elected a member of the Executive Committee and Mr. Lenhart was elected to the Board of Examiners for a three-year term.

Mr. and Mrs. Keast not only had a considerable part in the preparations for the Institute meeting and the pleasant entertainment of those attending but also showed most generous hospitality to the L. R. B. & M. group from the East, South and Middle West, all but one of whom were accompanied by their wives.

On the day following the adjournment of the meeting a luncheon was given at the famous Bohemian Club, which Mr. Keast had arranged so that the out-of-town partners might have the pleasure of meeting with the members of the San Francisco staff. Mr. Ross, Colonel Montgomery and Mr. Staub made talks, the brevity of all of which was in keeping with the Colonel's well-known standard for a talk, to wit, a short one indeed.

En route to the Coast for the Institute meeting, Mr. Staub had stopped over in St. Louis to address a joint dinner meeting of the St. Louis Chapter of the National Association of Cost Accountants and the Missouri Society of Certified Public Accountants on the subject of "The Revenue Act of 1939." About two hundred were in attendance at the dinner. Mr. Warner, manager of our St. Louis office, presided at the meeting which followed the dinner. A question and answer period followed Mr. Staub's address.

Another stop was made by Mr. Staub in Los Angeles where Mr. Gibson arranged a luncheon at the California Club for him to meet a number of the senior members of the Los Angeles staff and discuss some of the matters which are of especial interest to accountants at the present time.

Fall Outing of the New York Office

The Fall golf and tennis outing of the New York office was held at the Pelham Country Club on September 12, 1939. As usual, the tournament was preceded by many days of bargaining and skirmishing to achieve a favorable position in the matter of strokes to be given and taken. We were not favored with the bright sunshine that we have had on some previous occasions, but the rain held off and the last stragglers reported at the nineteenth hole. Some of the more hardy souls braved the chill atmosphere to take a dip in the pool, and the tennis courts received their share of attention.

The golf competition was for the Sinclair championship cup and for two group prizes in each of three groups arranged on the basis of relative playing ability.

The cup was won by J. W. Bower, with a net score of 68, and the other prize winners were as follows:

Group A:

First prize, E. O. Gerhardt
Second prize, A. J. Bretnall

Group B:

First prize, L. H. Rappaport
Second prize, I. H. Worden

Group C:

First Prize, J. E. Bierschenk
Second prize, D. A. Sale

Golfers, tennis players and spectators enjoyed a very good dinner in the evening, which was climaxed as usual by Mr. Sinclair's awarding of the prizes in his own particular style. After dinner games of skill and chance were indulged in until the hour dictated the close of a completely successful day.

W. N. V.

Notes

At the Second Accounting Clinic held October 20 and 21 at Pennsylvania State College, sponsored by the Harrisburg Chapter of the Pennsylvania Institute of Certified Public Accountants, Mr. Lenhart delivered an address on "To What Extent May Usual Auditing Procedures Be Relied Upon for Detection of Fraud?" A brief address was made by Mr. Fischer, President of the Pennsylvania Institute of Certified Public Accountants, at the luncheon on Friday, held in connection with the meeting.

Mr. Lybrand is serving as Comptroller of the Centennial Committee which, in behalf of the Young Men's Christian Association of the City of New York, is seeking to raise about a million and a half dollars, which amount is needed for the year's current budget and for various capital expenditures which are urgently required if the Association is to meet the needs and opportunities which are facing youth in the great metropolis of the western hemisphere. Mr. Lybrand and Mr. Staub had a table for ten at the dinner which was given under the auspices of the Centennial Committee at the Hotel Waldorf-Astoria on November 2nd, and at which the principal speakers were ex-President Herbert Hoover and ex-Governor Alfred E. Smith. About 1500 persons attended the dinner.

Mr. E. P. Ellenberger, of our Cleveland office, has been elected president of the Cleveland Chapter of the Ohio Society of Certified Public Accountants. We are always pleased when members of our staff receive recognition of this kind for good work done in our professional societies.

A number of members of our Cincinnati staff have been honored by election or appointment in various organizations dealing with accounting. Mr. O. W. Seifert was elected President of the Cincinnati Chapter of the Ohio Society of Certified Public Accountants, and Mr. A. J. Starr was elected a Director and Secretary-Treasurer of the Society.

Mr. S. L. McCormick is conducting a class in federal taxes, Mr. Starr a class in C.P.A. Review, and Mr. G. R. Becker one of the sections in Elementary Accounting, at the Y.M.C.A. evening schools. Judge Frederick L. Hoffman, senior Judge of the Court of Common Pleas, has invited Mr. McCormick to conduct lectures on Federal tax procedure before members of the local Bar Association.

Messrs. Joseph H. Eversmann, John R. Kiessling and Willis K. Waterfield recently passed the Ohio C.P.A. examination.

Colonel Montgomery was one of the speakers at the formal opening of the new tropical garden at the main conservatory of the New York Botanical Gardens in Bronx Park. He represented the Garden's board of managers, and in the course of his address said: "In these highly emotional days we need distractions which are novel enough to arouse new interests in us. If those who have no hobbies to fall back on would take up the study of certain families or species of trees or flowers or plants, it would add ten years to their lives."

The September 1939 issue of *The Accountants Digest* contained digests of the articles on Accounting Aid to Industry, by Mr. Marsh, and on Some Observations on Inventory Methods, by Mr. Staub, which had appeared in Part II of the Fortieth Anniversary issues of the L. R. B. & M. JOURNAL.

The following recently passed the New York State C. P. A. examinations:

Albert D. Battisti
Harold C. Chinlund
Huyler L. Lisk
Thomas P. O'Connor
Charles B. Peck

Messrs. Fred M. Breslin of our San Francisco office and Henry S. Sekerak of our New York office have been admitted to membership in the American Institute of Accountants.

The following members of our New York staff were recently admitted to membership in the New York State Society of Certified Public Accountants:

Edwin M. Bush
Huyler L. Lisk
Thomas P. O'Connor
Charles B. Peck
John S. Warner

Federal Tax Handbooks

[*Continued from page 19*]

returns based on 1939 earnings will be substantially on the basis of the law as it existed *prior* to the passage of the new Act. Further, the 1939 Act made no change in the law of gift or estate taxes.

In view of the foregoing, the current 1938-39 editions of Montgomery's *Federal Income Tax Handbook* and *Federal Taxes on Estates, Trusts and Gifts* may be used in considering questions arising in respect of 1939 returns or transactions to be consummated before the end of the year. Of course, in any specific case, research should be made to see whether there had been any regulations, rulings or decisions since the publication of the books which would have a bearing on the question under consideration.

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